No. 9242

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

10

Before: Hon. William Denman, Circuit Judge;
Hon. Clifton Mathews, Circuit Judge;
Hon. Albert Lee Stephens, Circuit Judge.

West Coast Life Insurance Company (a corporation), Pacific National Bank of San Francisco (a National Banking Association), et al.,

Appellants,

vs.

Merced Irrigation District,

Appellee.

ORAL ARGUMENT BY STEPHEN W. DOWNEY ON BEHALF OF MERCED IRRIGATION DISTRICT.

Monday, January 29, 1940.

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FILED
FEB - 9 1940
PAUL P. O'BRIEN,
CLERK

Pernau-Walsh Printing Co., San Francisco

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Monday, January 29, 1940.

Judge Denman. We will hear from the appellee.

ARGUMENT OF STEPHEN W. DOWNEY, ON BEHALF OF APPELLEE, MERCED IRRIGATION DISTRICT.

Mr. Downey. Your Honors, I have acted as counsel for the Merced Irrigation District for some twelve years,

and I hazard the statement that there has not been some period of every twenty-four hours during that time, or certainly during the last eight years, that I have not had occasion to consider the problems and the perils of the bondholders and the land owners. As Mr. Cook and Mr. Childers very properly say, these are common problems. I would give a good deal to be able to paint that picture as it actually is. Every time I try to do it, I realize the utter inadequacy of words to do it, so inadequate is the spoken or written word against the reality.

We start with a district which was conceived during the boom agricultural costs of the first World War in 1919. In 1920 the agricultural index ran over 200. At the time of trial November 1938, it was about 94 and it was down as low as 65 in 1932,[1] which gives you a picture of the relation of the times. 1920 was a period when the optimism of the bondholders and land owners ran skyward; when $5,500,000 could be spent merely to move a railroad, a very trifling part of the project.

Then we pass through the intervening years, when the agricultural index was still high: 1925, 1926, 1927, 1928—still high; 1929, still high, 1930, lower, 1931, still lower, and reaching an all-time low in 1932. Then rising somewhat again, with a big dip in 1938, but never reaching the prices of 1926, 1927 or 1928 and '29. And those latter prices were not even comparable with the prices at the time the District was formed or conceived in 1919 and 1920.[2]

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1. See Appendix A, brief of appellee, Merced Irrigation District, extract from U. S. Department of Agriculture Report.
2. Id.

ASSESSMENTS NOT YIELDED BY LANDS.

Now, as the years went by in that District, commencing with 1926, 1927 and 1928, when, as I say, prices were still comparatively high, there gradually came the realization that even then the assessments were not being paid out of the land; that the money was coming in, not from the land, but from outside sources, based upon the hope and prayer that the District would be colonized and subdivided, and that the war prices would——

Judge Denman (interrupting). What do you mean by "coming from outside sources"?

Mr. Downey. It came from savings, your Honor; it came from money borrowed; it came from the surpluses of corporations which owned property there, and from the savings accounts of individuals who farmed the land.

Judge Denman. Is this in the record?

Mr. Downey. This is in the record, your Honor, yes (R. 440, 441, 442, 456, 462, 463, Ex. 35, pp. 114-124).

Then came the default in 1931, and from then on the attempt to hold up the value of those bonds, to maintain the credit and the stability of the District and of the county, with prices falling, and the final realization that collapse was inevitable; delinquencies mounting from 17 per cent to 37 per cent, to 62 per cent and the absolute certainty that if the District continued to function by servicing its bonds from there on, after the delinquency had reached 62 per cent, that it was merely a matter of a year or two until the delinquency was 100 per cent. When the outside sources of payment were exhausted, default was inevitable.

Judge Denman. What does the record show with regard to earning power during that time?

Mr. Downey. May I come to that in a moment? I will point out that the District never did have an earning power to service a bond issue of sixteen million, and if it is able to service the refunding bond issue which is to go to the R. F. C. when refinancing is complete, it will be able to do it only by the narrowest margin of safety.

BACKGROUND OF PLAN.

At that point, when the realization came that 100% delinquency was inevitable, unless defaults and delinquencies were immediately arrested, the bondholders stepped into the picture, and from there on, may it please your Honors, we find an able and aggressive bondholders committee and we find the Irrigation District cooperating to the uttermost with the bondholders to work out this problem, which was indeed a common problem. The statement made here in the argument about tax strikes and repudiation is unsupported by a single syllable of testimony. The evidence is all the other way.

Now, what followed, may it please the court? Investigations by the bondholders, and reports and studies and audits by the bondholders; the most intensive efforts on the part of the Bondholders' Committee and various large bondholders, big banks that had statistical agencies and statistical assistance at their finger points, to suggest a solution. At last, your Honors, they reached this point: that in order to determine how the problem could be met, a study should be made of the tax-paying ability of the District, and so they go to the University of California, the most outstanding, the most disinterested, the most able

to make a study of that kind. That study is made not by the District alone, not by the bondholders alone, but at the joint request of both (R. 434), in order to determine what could be done in this common situation. And finally, your Honors, we have *this* plan—the one before the court —the final effort of the bondholders to save what they could before all value was lost, the only plan which ever seriously interested the bondholders, the only one suggested which carries the stamp of feasibility.

Judge Denman. Does the record show that the University has advocated this—or presented facts on it?

Mr. Downey. The Giannini Foundation, or the Benedict Report, which the University of California prepared—it is all the same thing—the study was made officially by the Giannini Foundation of the College of Agriculture of the University of California, and Dr. Benedict, who is professor of agricultural economics on the University staff, was personally in charge.

Yes, it is a University of California report, your Honor. It advocated no particular plan. It merely found the facts on taxpaying ability of the District so bondholders and land owners could act intelligently (Ex. 35).

Now, this report, to my knowledge, is the only scientific, comprehensive report that has been made of tax-paying ability on a large scale and I will point out the detail and the importance of that report in a moment. Now, it is easy enough to go into an irrigation district and ask Mr. John Doe or Mr. Richard Roe, to testify as to what the lands can pay; that is not a difficult thing. It is easy enough to say, "Well, the farmers in peaches went broke", or "The farmers in grapes went broke". That can give us a

portion of the picture, but by no means the whole picture. To determine what a district or a governmental agency as an entity can pay is obviously a very difficult and very different operation, and in this case, the report or the survey, was made by the University with the idea of determining the facts, disinterestedly, fairly, in the interest of both bondholders and land owners and also in interest of the public because by this time the public interest generally was also vitally affected.

Now, what does this report show? In the first place, it is based upon a classification and appraisal of the lands in the District. That classification and appraisal was made by Mr. Cone, representing the District, and by Mr. Underhill, representing the Bondholders' Committee —again, the common effort to attain a fair determination of an essential fact (R. 742, 446, Ex. 35, pp. 126-133). Mr. Cone classifies the lands as approximately 40,000 Grade 1 lands, approximately 50,000 Grade 2 lands, and approximately 80,000 Grade 3 lands, or marginal areas (Ex. 35, p. 130). He points out that the land has no value at all, no market value at all, unless the bond issue is placed upon an "ability to pay" basis (Ex. 35, p. 127). Now, obviously, that is true. To talk about land having market value where it is encumbered by a bond issue that the land owners cannot pay is an absurdity. I submit, your honors, it is a contradiction of terms. Appellants speak in their brief of these lands having a value of $50,000,000, quite independent of the fact that it may be encumbered by a bond issue that the lands cannot pay at all.

Judge Denman. I think they are referring there to the fact that the tax sale might go on, all the property acquired

by the District, and then it is valued as against the value of the obligations, taking into consideration the Supreme Court decisions; I think that is what they mean.

Mr. Downey. I didn't intend to come to that point; I will come to that in a minute.

VALUE OF LANDS DEPENDENT UPON ABILITY TO PAY.

Judge Denman (continuing). Here, when we are talking of value, we are now assuming that the District performs all the things it promises to perform. Amongst other things, it promises—implied in the bonds—to go and acquire the land under the tax sale and sell it under tax sale; when they have so acquired it and also sold it, and it exceeds the amount of the composition offered—or if it would not do that, then a bankrupt is keeping part of his property and not paying all of his debts; that is the theory I caught that argument on.

Mr. Downey. I am a little ahead of my argument on that, your honor, but it must be clear that if the District cannot pay sixteen million dollars, that the lands cannot have a value anywhere near sixteen million dollars, because, by a process of pyramiding and collection of delinquency, the load keeps piling on one piece of land, and then on another, and then on another, until they can't pay at all.[3] If the District acquires all of the land and then sells one piece, that one piece immediately becomes subject to the entire bond issue—the vicious circle repeats itslf.

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3. See Appendix B Merced Irrigation District's Brief, describing process of pyramiding.

Every piece of land in an irrigation district is surety for the whole issue and for every other piece of property. Therefore, unless the bond issue is upon an "ability to pay" basis, nobody in the end can pay, nobody will buy land in the district and it has no market value. Of course, the very question we are seeking to answer here is whether the refunding bond issue represents the "ability to pay" basis. If it does, the lands have value, but not otherwise. So what we have to determine here is "ability to pay". Value is collateral to that. It is obviously a contradiction of terms to assume that lands can have value in excess of a bond issue which is a charge against them if they cannot pay it. "Ability to pay" is precisely what we are attempting to determine in this case. Once "ability to pay" is established, "value" follows automatically. But if you don't have "ability to pay" you can't have "value". However, I will pass that for a minute; I want to get into the Benedict Report.

BENEDICT REPORT.

Now, Mr. Benedict took all the farms in the District in excess of twenty acres, some 1600-1700 farms (R. 435), on the theory that that was the land which, in the main, would have to support the bond issue (R. 470). He then drew by lot a 20 per cent sample from those farms, so there would not be any question as to the fairness of the sample—all this being done under the supervision and with the cooperation of Mr. Fullerton, representing the Bondholders' Committee—and he gets a certain sample, some 300 farms, which is an enormous sample—the first study of this kind—then he makes an intensive study—

about nine months—to determine the costs of production and the revenue or income of the properties in 1929, 1930 and 1931—1929 was an excellent year. He found that all of those properties operated at a loss after payment of labor, out of pocket expenses and county taxes, with the exception of a few of the Grade 1 lands—about 40,000 acres of them in the District—during 1929 alone, and that after deduction of depreciation, all of the lands operated at a loss (R. 437, 471).

Then the question was raised as to whether that was a fair study, because it was claimed economic conditions in the District were better in 1926 and 1927 and 1928, as of course they were (Ex. 35, p. 114). Mr. Benedict then goes back, and the records not being available in detail as they were for the last three years, and the time being short, because they had consumed nearly nine months in this first study, takes 26 representative properties in the District which pay an assessment in excess of $2500—about 40,000 acres of those properties—and he makes a study of them, and he finds that the total net income on those 26 properties, before payment of taxes and assessments, in 1926, 1927 and 1928 was minus $246,000 (R. 441). In other words, before paying operating expenses $246,000 of outside money from outside sources was required to be put into those properties. It was not yielded by the lands. And after payment of the taxes and assessments, and the operating expenses, there was a net income of minus $1,300,000. $1,300,000 therefore was required to be paid on those particular properties (R. 441, Ex. 35, p. 116 et seq.) from sources outside the land.

Judge Denman. Not as capital investment.

Mr. Downey. It came from outside sources.

Judge Denman. None of the million dollars was capital investment?

Mr. Downey. No. In other words, during the years 1926, 1927, and 1928, when prices were high, when economic conditions were good, when the District apparently was prosperous, even then, the money that was required to meet these assessments was not being yielded by the land.

Now, not only that, but Dr. Benedict was called as a witness at the trial before Judge Cosgrove at Fresno in 1936, the first trial, under the first Bankruptcy Act. He was cross-examined in that case, your honors, as I remember it, for nearly a day. His testimony was stipulated into the record in this case before Judge McCormick, and he not only bore out his earlier statements, but he showed that even if prices returned to the 1919 level—which he said was utterly impossible, so far as anybody can predict —get this—that even then it was doubtful if the District would be able to carry on; and in connection with the discussion as to prices and other items, he indicated that the margin of safety possessed by the R. F. C. on its refunding bonds was exceedingly small (see R. 462-463; 471).

BONDHOLDERS' LETTER.

Now, after Doctor Benedict's report had been submitted, the parties again got together in an attempt to work out this problem. Now, mind you, there is no money at that time, no chance to make a cash arrangement for refinancing with the bondholders; at least, nobody is willing at that time, or since, to come forward with any money,

except this relief agency in Washington, and at that time there is no loan available from the Reconstruction Finance Corporation, and the parties sit down to work out this problem with the Benedict Report before them, which they both accept, although, admittedly, many inferences could be drawn from that report.

I hold in my hand Exhibit 37 (R. 736-754), which is the letter by the Bondholders' Committee, dated December 15, 1933, to the bondholders, explaining to them the condition of the District; this letter, among others, your honors, is signed by Milo Bekins, Reed Bekins, Victor Etienne, Hon. James N. Gillett (R. 754), and Myford Irvine, all members of the Bondholders' Protective Committee and all in representative capacity, or otherwise, appellants here. They represent a very large block of the dissenting bonds here.

Now, the bondholders are told by their committee that it is pleased to announce that a refunding plan has been adopted by the Board of Directors of the Merced Irrigation District, and that the voters have approved it at an election held November 22, 1933. This is the first refunding plan, the paper exchange. I might say to your honors the people of Merced approved that refunding plan by a vote of nearly 100 per cent, in an attempt to work out this problem, that then being the only plan which seemed feasible. Remember there was no money in cash then available for refunding purposes.

Judge Mathews. What was the date of that?

Mr. Downey. That is December 15, 1933.

The bondholders are told that the Committee now has 35 per cent of the bonds, and that in order that this plan

be consummated, the bondholders must deposit additional bonds thereunder, the District already having approved it (R. 737).

Judge Denman. What is the date of this study, the Giannini Foundation?

Mr. Downey. The study was completed just preceding this letter (Feb., 1933 and June, 1933—see Ex. 35).

The Committee points out the District's existing critical financial condition (R. 738). It speaks of the delinquencies mounting from 17 per cent to 37 per cent (R. 738); the decreasing farm prices, refers to the delinquency of 62 per cent (R. 739) which had been the last preceding delinquency; says that if it is necessary to levy taxes next year, the rate will be $15.60 per hundred dollars of assessed valuation (R. 740), says the 62 per cent delinquency came about as a result of a tax levy of $8.90; states that the foregoing figures

> "have been taken from the District's records, which the Committee has relied upon and checked to the best of its ability. It cannot, of course, guarantee them but it believes them to be correct" (R. 740).

The letter speaks of the shortage of funds for the operation and maintenance of the District; that such expenditures have necessarily been curtailed; that the irrigation system needs extensive repairs, betterments and extensions (R. 740).

> "As a result of its own investigation the Committee is of the opinion that conditions in the District are in fact as represented by the District's officials" (R. 741).

I cannot tell your Honors how many investigations and studies were made by the bondholders.

Then, the letter points out the causes for the District's inability to meet its bonded debt: first, that large areas of land were included, through inaccurate information

> "as to the capability of certain lands, and partly through desire to include as much land as possible in the District in order to spread the financial burden" (R. 741)—

as a matter of fact it just worked the other way. It points out that Mr. Cone

> "at the request of the District, completed a thorough classification and appraisal of the lands within the Merced Irrigation District"

and his

> "conclusions, in general, are verified by the Committee's representative, Mr. R. L. Underhill" (R. 742).

The letter then says that, of the 171,000 acres in the District, 90,000 acres are good land and 80,000 acres, taken as a whole, are capable of bearing but little of their share of the District's bonded indebtedness.

> "The future development of this land is problematical and the Committee is of the opinion that the possibility of substantial immediate income from these lands must be discounted" (R. 742).

Then, taking the good land, as found by the Bondholders' Committee—some 90,000 acres—they say that 17,000 acres of that land are above the level of the gravity distribution

of water—water has to be boosted up to those lands at a loss—leaving some 74,000 acres out of 171,000 acres, and the cities, upon which the burden of the District's obligation, in large measure, must rest (R. 743).

Then comes a comparison with the tax rates of Districts which are true competitors of the Merced District—we don't compete with Districts in Southern California, nor are we comparable with Districts in Southern California, or other districts mentioned here, but Modesto and Turlock are our immediate competitors—same type of land, same type of products, and exactly the same climate. The letter points to an assessment rate of $3.10 for Modesto and $3.00 for Turlock, and it compares that with the last—what we call the legal rate for the Merced District, $8.90—which produced a delinquency of 62 per cent (R. 744).

The letter then refers to the failure to colonize the District, which had been hoped for at the time of its formation; irregularity of the power income, which, of course, requires the building up of substantial reserves to guard against the collapse of farm prices and dry years and points out that the District then had—and this figure is rather important—about $1,167,000 of delinquent assessments (R. 747).

Now, this very letter refers to the University of California or Benedict report:

> "In the early part of 1933, the Agricultural Experiment Station of the College of Agriculture of the University of California completed a survey of farm incomes and expenses in the Merced Irrigation District from 1926 to 1931."——

Appellants say this report is only from 1928 to 1931——

> (Continuing) "While the compilation of such a survey is attended with extreme difficulty and the results must be carefully interpreted, the general conclusions brought forth were that farm income available for the payment of District assessments during 1930, 1931, 1932 declined at a rate even greater than the fall of farm prices, and that during those years the Irrigation District assessments required under the present debt could be met out of the earnings of only a small portion of the District's best and most highly developed land" (R. 747).

Then follows a statement of the first refunding plan of 1933: The District shall pay the bonds and coupons due January 1, 1933, and shall make no further payments for that year, no interest for July 1, 1933 (R. 748). That is important, because there is some point made by appellants as to our failure to take certain action with reference to coupons dated July 1, 1933.

Then follows the detail of the plan, which contemplates the exchange of one bond for another maturing in 1983, 50 years in the future. It is a sinking fund bond with some slight reduction in interest, and a period of seven years during which there is a substantial reduction in interest (R. 749).

Then,

> "During the period of more than two and one-half years in which the Committee has been negotiating with the representatives of the Merced Irrigation District, the members have given a great deal of their time to properly inform themselves as to the conditions which must be met by any workable re-

funding plan. It has had the benefit of comprehensive investigation of underlying facts, not only by its own observers, but by the College of Agriculture of the University of California. In the opinion of the Committee, the refunding plan adopted by the District is designed to insure the maximum to the bondholders and, at the same time, not to impose burdens upon the District which will be beyond the ability of the land owners to meet." (R. 750.)

Then,

"The Committee has assured the District that it will cooperate in any application made by the District to secure Federal or State aid in the purchase or refinancing of the District's bonds, and that in the event that funds for such purpose are made available from a Federal or State agency, such offer will be submitted to the bondholders." (R. 752.)

In other words, the District, having adopted this first refunding plan, now submits it to the bondholders with the stipulation on the part of the District that it will apply for Federal funds, and if it gets a loan, it will submit it to the bondholders.

FIRST REFUNDING PLAN REJECTED BY BONDHOLDERS. CASH PLAN APPROVED.

In the meantime, the Bondholders' Committee tries to secure deposit of the bonds under the first refunding plan, and, your Honors, appellants can talk about this first refunding plan not having contemplated a reduction in principal; why, it was mere paper exchange. For us to really realize that situation—they were putting off the inevi-

table day, a bond due in 1983, and, of course, the hope, I believe, that it would be possible to go out and buy in those bonds at heavy discounts, say fifty cents on the dollar, in the meantime.

Well, what happened? The Bondholders' Committee starts to solicit deposit of bonds under the first refunding plan, and a year later they have secured only 60 per cent (R. 497, 499). They had 35 per cent at the time the letter was written (R. 737) and after a year of intense solicitation they got up to 60 per cent and there it stopped. The bondholders were not interested. They refused to sanction the plan.

Now, in the meantime, the Merced Irrigation District representatives had gone back to Washington and had made application for a loan. Counsel says we represented that the power income would average $500,000 a year (Ex. OO, p. 105). We did. We went back to Washington and we made the very best showing possible to make, in the hope that the loan would be the biggest the District was able to pay; we made the best showing we could. We went there as any debtor goes to a bank and begs for money. No one else, no underwriter, no bank, nobody was willing to help, and all that could be suggested, in default of relief money, was exchanging one bond for another.

We came back from Washington and we submitted the R. F. C. offer to the Bondholders' Committee. What did the Bondholders' Committee do? Was there any high pressure or coercion? Absolutely not.

The Committee said, "We will submit the cash plan to the bondholders and see what they want." So they wrote the bondholders and asked them which they wanted,

the first refunding plan, or the cash plan (R. 496). The bondholders had the facts before them. The result of many studies. They had the letter from the Committee dated December 15, 1933 (Ex. 37) which I have quoted from. They had the Benedict Report, and many other things.

And, your Honors, the replies came back like an avalanche, 63 per cent of the bonds outstanding, an enormous vote, because many of the bondholders couldn't even be reached, voted to take the cash plan. Only about seven per cent voted for the first refunding plan. The District had nothing to do with it. In number, five to one voted to take the cash plan (R. 499, 503). This was a bondholders' plan, not a landowners' plan. We were not high-pressuring anybody. The bondholders said, "we want the cash," as I believe any man who was conversant with the affairs of that District would also have concluded. And there is no evidence that more than 7 per cent wanted the first refunding plan at any time.

So then the bondholders' committee, because of this referendum, adopted the cash plan, and then deposit was called for on the basis of the cash plan, and in October, about eight months later—the plan was adopted in February, 1935 (Ex. 13, R. 586)—there were on deposit nearly 90 per cent of the bonds for the cash plan (R. 344). That is what the bondholders thought about the cash plan.

Now, on October 4th, 1935, the R. F. C. directed the Federal Reserve Bank in San Francisco to buy these bonds that had been deposited; the money was paid to the depositaries and bills of sale were given to the R. F. C. and it is today the holder of the legal title to those

bonds, in almost every instance by bill of sale (R. 345), although in the last few months the custom has been for a bondholder to walk into the Federal Reserve Bank and the bond would be purchased for the account of the R. F. C. over the counter (R. 348).

In April of 1935, we filed in the Bankruptcy court under the first law. That case was tried in February, 1936, before Judge Cosgrave, resulting in a judgment approving the plan (Ex. OO, pp. 222-227).

Judge Mathews. What was the date of the original Chapter 9, Mr. Downey, Sections 78 to 80?

Mr. Downey. Your Honor, I can't give you that exactly.

Mr. Childers. May 24th, 1934.

Mr. Downey. Thank you.

That judgment—reversal of that judgment became final based upon a denial of certiorari by the United States Supreme Court in October of 1937 (R. 519). In the meantime, the State had enacted an Irrigation District Refunding Act (Chap. 24, Stats. 1937) which provided in effect for the condemnation of the dissenting bonds. The District filed under the State Act. There was an announcement of a decision on the preliminary features of that Act in March of 1938 (R. 381-383), then the decision of the United States Supreme Court followed, holding the second Bankruptcy Act constitutional. The District filed under that in June of 1938 (R. 8, 36) and the action which is before your Honors was tried in November 1938.

In the meantime, from the adoption of the cash plan in 1935, right on through the present moment, the District has operated practically under the plan, by virtue of

the stays which have been involved in these different suits and by virtue of certain emergency tax legislation which passed by the State of California, commonly known as Section 11 of District Securities Act (Stats. 1933, Chap. 60, as extended). We have had an emergency tax rate all of that time; the rate for the last few years has been $3 a hundred (R. 403). Now, the fact that we have reduced our rate to that figure, plus the fact that the landowners have taken advantage of certain emergency legislation permitting redemptions over a ten-year period, plus the fact that we have had two enormous power years —which I will come to in a little—plus the money which the Federal Government has poured into farming communities in the form of Federal Land Bank loans, has resulted in the District, during the last few years, not being prosperous, but being able to get along. Redemptions from the old delinquencies have come in at a substantial figure—several hundred thousands of dollars. The $3 tax rate, because it is low, has brought in more money. If we raise the rate, we really have no assurance we will get more money, and the encouragement resulting from the belief down there in the District that they are refinanced, has resulted in a present condition which is somewhat—well, it is certainly much better than what we have had before; we are getting along. The picture could change over night, either by reason of drought or shortage of water, or reduction in farm prices, or floods or a dozen other contingencies. There are many things which could change the picture over night and wipe out everything that we have been able to accomplish in the last few years.

Judge Denman. Was your drop in income due to drop in run-off, or was it due to a drop in demand?

Mr. Downey. No, there was no drop in demand; we have a firm contract for 20 years with the San Joaquin Light & Power Company; it is lack of run-off and other factors which enter into it, which I would also like to discuss in a moment.

APPELLANTS' REPLY BRIEF ON FAIRNESS OF PLAN.

Now, your Honors, the reply brief of the appellants, is in many respects, on the fairness of the plan, a substantially new argument and new matter—something not advanced before—as is also the argument of appellants here the other day on fairness. That is why it is so essential I should answer the new points in argument. That is primarily why I am talking about fairness of the plan.

It was asserted in the opening argument of counsel for the appellants here that the District Court ignored the facts, relied on the consents as establishing the fairness of this plan. Your Honors, that simply is not so. Judge McCormick's opinion goes into all of the essential elements involved in fairness—ability to pay, the Benedict Report, Mr. Momberg's testimony,[4] the appreciation in the value of the bonds. He also relies on the fact that the District is operating now on an emergency basis and that

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4. It is said in Appellants' reply brief, and in their oral argument, that Mr. Momberg's testimony showed a substantial profit. To the contrary, his testimony (R. 474-494) summarized, shows farm income on fifty properties, 1932 to 1938 inclusive, after payment of taxes and farm expenses but before deduction of insurance, depreciation and head office overhead, to be $30,932.00 or an average of $4,414.00 per year. Deducting estimated share of expenses for district supervision which should be allocated to the same fifty properties (Merced office) or $5000.00, leaves the fifty properties in the red without further proper deductions for insurance, depreciation, etc.

the experience in meeting the assessments resulted, even at the rate of $8.90 per $100 in a 62 per cent delinquency, shows that the District obviously could not carry a bond issue of sixteen million, and attributes the better condition to the operations of the R. F. C. There was no contention at the time of trial, as is now made and as made in appellants' reply brief, your Honors. The contention as to the fairness of the plan is really made in the reply brief of appellants for the first time. It is an after-thought, the primary contention being before that we didn't owe sixteen million, that we only owe what we owe the R. F. C. plus what is owed on the outstanding bonds of appellants and therefore we could pay the dissenters 100 per cent of principal.

Mr. Douglas was reported by Mr. Cook to have made an address before the American Bar Association sometime ago to the effect that no consent should be solicited—if I got his statement correctly—until the plan was in court. Well, if he made such a statement as that he was referring to Section 77-B. As a distinguished lawyer before he was on the United States Supreme Court Bench, I call your attention to the address he delivered before the American Bar Association in 1937, after the *Ashton* case had been decided. I quote briefly (Legal Notes on Local Government, 1936-37, Vol. 2, p. 81 et seq.):

> "It is agreed that the most important process in debt readjustment"—he is speaking now of municipal debt readjustment—"is negotiation of its terms. * * * Few will dissent from the conclusion that this process of negotiation should be conducted openly and honestly by bona fide representatives of the debtor and of the creditors; nor can there be disagreement from

the conclusion that when a fair agreement is reached by a process of give and take between such bona fide representatives upon the basis of a full disclosure of all material facts, there should be some machinery for putting it into effect (p. 81). * * * Fairness of a plan is not always ascertainable by examining the terms thereof. Normally it will be necessary to inquire into the background of the plan and the activities of the negotiators to ascertain if the antecedent and collateral phases of the plan are free of overreaching and coercion.

"Conspicuous among such matters is the method by which assents to plans have been obtained. * * * Traditionally, one of the criteria of a fair plan has been the number of consents which have been obtained. But unless consents have been obtained openly and freely this essential hallmark of a fair plan can exist only in form, not in substance. The reorganization field is replete with instances of coercive practices whereby consents have been obtained, and of oppressive methods by which security holders have been whipped into line behind particular plans" (p. 86).

Then he goes on to say that

> "While it may be wholly for bondholders to accept 50 cents on the dollar, it may be grossly unfair if that figure is reduced to a net of 45 cents by virtue of the Committee's deductions" (p. 86).

Now, on the fairness of our plan, consider this background: that everybody agreed that refinancing was necessary; that they had before them a disinterested, unbiased, able, scientific report by a state agency that, with that before them, the bondholders, themselves, said "We want the cash". And under those circumstances, what could be

fairer? What could be more reasonable, and wherein is there left any claim such as repudiation, or tax strike, or coercion, or similar charges that have been bandied here, your honors, charges not bandied at the time of this trial, or in the other trials?

APPELLANTS CLAIM THAT DISTRICT DID NOT ACT IN GOOD FAITH.

Now, at that point, I do want to refer to two charges that appellants did make in their opening brief. They did say that the District has not acted in good faith, that it has been guilty of constructive fraud. They have not argued that here, but they argued it in their opening brief and the reply brief. They say that arises by reason of the fact that the District diverted $717,000 from the Bond Fund to the General Fund. The last bond service levy was made in 1932-33; that is the levy that went 62 per cent delinquent. In subsequent years, as I pointed out, money came in on redemptions. In the meantime, the legislature had passed a law, Section 11 of the District Securities Commission Act (Stats. 1933, Chap. 60) providing that there need be no levy for bond service during this emergency period, and none was levied. The tax redemptions which were based on the tax levies prior to 1932-33, were properly put in the General Fund. Of the $717,000, all of it, with the exception of $320,000, represents delinquencies on levies prior to 1932-33, and all of the bond obligations, your Honors, up to July 1, 1933, have been paid in full (R. 400-404), so that leaves it not $717,000, but $320,000. That is the money that has come in since 1933 on the delinquencies under the levy of 1932-33. Now, whether the

trust follows through so that it may properly be said that the money should go into the bond fund, I don't purport to argue. I think it is debatable, but I don't regard it as important. What happened was this: When the first refunding plan was adopted, as you will observe from the letter that the bondholders' committee sent out and which I have quoted extensively, it was not contemplated that any interest would be paid on coupons due July 1, 1933 (R. 748). The coupons of January 1, 1933 have been paid (R. 400-404); that was to stand as payment of interest for that year, and accordingly, the District, in the utmost good faith continued, as these delinquencies came in, there having been no subsequent levy for bond service, to put the money in the General Fund. The Bondholders' Committee knew all about it. In their own letter to the bondholders it is stated that there will be no payment of interest due on July 1 of 1933; and, moreover, this plan before your Honors, and the plan before Judge Cosgrave, and the plan in the state court, contemplated there would be no interest paid for July 1, 1933, yet it is contended that because the District did not put that $320,000 in the Bond Fund, it is guilty of constructive fraud.

Judge Denman. What happened to that, was it spent?

Mr. Downey. No; I am glad your Honor spoke about that. There is no contention here that the District has been extravagant; there is no contention that it has squandered any of this money, or that it has spent this money for unlawful or improper purposes. Every dollar that we have been able to earn in that District from redemptions, or from power, or from assessments, has gone right into the General Fund of the District.

Judge Denman. That is not the question. I asked about the $320,000.

Mr. Downey. That has gone there, too.

Judge Denman. Has that been spent?

Mr. Downey. Well, it has all gone into the General Fund, your Honor. The bond fund has been non-existent since 1933. Money has come in and money has gone out of the General Fund and today the surplus which represents the excess of what we have been able to save over what we have been compelled to spend, is $1,500,000, so there it is; there is the $320,000 included as a part of the $1,500,000. If the $320,000 should go in the bond fund—which of course it would not if this plan is approved—there it is.

Now, nobody has ever claimed that we have operated on an extravagant basis; no one has ever claimed that we have taken the money and put it aside for improper purposes or spent it unnecessarily. It has been regarded as a trust fund. There it is. Maintenance has of course gone on. The District has, by economical operation, by reaching out for every dollar it is possible for the District to get hold of, built up its cash. If the bondholders are entitled to that $320,000, there it is. I made that statement in my brief. In their reply brief, appellants say: "But you did spend money for the Crocker-Huffman contracts." Of course. Those are contracts under which we are purchasing an encumbrance on our water rights (R. 511); without that purchase our underlying water rights would be jeopardized. Appellants say: "You did spend money for maintenance and operation." We did, obviously. If we didn't keep the District operating

the bondholders wouldn't have any security; there wouldn't be anything left for anybody. We are trying to keep the canals open and the farmers on the land in an attempt to service whatever may be the final bond issue here. All this was essential. So, also, was payment of bond obligations through January 1, 1933.

For eight years we have been under the scrutiny of the bondholders. We have filed annual reports and financial statements with the District Securities Commission, we have published financial statements annually as Section 14a of the California Irrigation District Act (Stats. 1917, p. 756) requires (R. 827-885). Engineers and bondholders have been down there and looked at our books. Appellants now say, eight years after this controversy arose, that in our balance sheet, Exhibit 26 (one of many financial exhibits), we have over-stated our liabilities and we have understated our assets. Now, may it please your Honors, that is based upon a triviality. It is not true in my opinion that Exhibit 26 is not correct; I think it is correct. We have an affidavit of a certified public accountant and others (Affidavit of Mr. Lumbard, R. 254 and see affidavits pp. 257-261)—it is a matter of bookkeeping. But anyway it is a triviality. Appellants take one exhibit, probably the least important exhibit in the case, Exhibit 26, a balance sheet. Of course, a balance sheet is supposed to show net worth. You don't ordinarily find balance sheets for the United States, or the State of California, or the Counties, because you don't show net worth as to them. It is not important. However, there was a balance sheet put in along with all of the other exhibits at the trial in November 1938.

In the other exhibits, and in the testimony, anything that any man could properly ask about finances is set forth clearly, but appellants take Exhibit 26, by itself alone, and they say, "You have over-stated your bond liability there by $387,000 principal."

Everybody that ever had a bond of the Merced Irrigation District knows that the bond principal is $16,190,000. In Exhibit 26 appears the entry, "Matured bonds $387,000," which appellants say—I don't know, I am not enough of an accountant to know—makes that balance sheet show that we have an accrued bond liability principal of $387,000 in excess of $16,190,000. It is negatived by every other exhibit and by every syllable of testimony. Then appellants say, "You over-stated your interest liabilities in that balance sheet." "How did we do that?" "Well, you say that you owed some $824,000 more in interest than you really did owe." "Why?" "Well, that represents the $824,000 you paid R. F. C. in interest." It should show as a credit on Exhibit 26. Whether that is a credit on the interest—the amount paid the R. F. C. is certainly a debatable question—but the absurdity of the thing is that no one ever disputed that that money was paid to the R. F. C., and the point I am now making is that whether the entry is right or wrong it could not have misled anyone. The payment appears over and over again in the District's testimony. It was an admitted fact (R. 369, 764).

Then, they say, "You didn't state all of your assets." "Why not?" "Well, you didn't include in this balance sheet (Ex. 26) which was prepared as of November 1938, the time of the trial, the asset resulting from the

levy of your assessment in 1938 for operations in 1939." We levy in September 1938 and we collect in December, and later on, to meet the obligations of 1939, and not having included the obligations of 1939, we did not include the tax levy—and, I think, very properly so. Now, it is from that sort of material, may it please the Court, that charges are made, and they are the only charges made of any lack of good faith on the part of the District; and I submit, your Honors, looking at the background of this plan, the method by which these negotiations have been conducted, that the District stands up for having been fair and honest, and for having attempted, and still attempting, to meet every dollar of its obligation that it can.

Judge Denman. We will take a five-minute recess.

(After recess:)

VALUE, MERCED DISTRICT BONDS.

Mr. Downey. I want to say a word, your Honors, as to the value of the bonds of the District. In the closing brief of Appellant (page 19) it is asserted that it is undisputed that there was a bid of 56 for the bonds of the Merced Irrigation District, February 5th, 1935, eight months before disbursement. That is not correct. The record shows (R. 521) that on February 5, 1935 there was a bid of 56 for the Merced Union High School District Bonds, not Irrigation District Bonds. On the other hand, the record is clear—there is no dispute about this—that the bonds of the Merced Irrigation District reached a low at the end of 1931, and during the year 1932, when they were as low as 16 cents on the dollar (R. 500). In

the spring of 1934, which was after we had made our application to the R. F. C. for a loan, they were selling at 28 cents, and they fluctuated between 28 and 32 cents until the fall of 1934, when the R. F. C. loan was granted, when they appreciated in four or five days to as high as 33 to 44 cents, and gradually increased up to 51½ cents when the R. F. C. commenced to buy up the bonds (R. 500). So that, notwithstanding the assertions in the reply brief of appellants and what I understood to be assertions in the Argument, here, the record is without conflict that the bonds of the District appreciated from at least 28 to 32 cents up to the settlement price, after the R. F. C. made this loan, and that they were as low as 16 to 18 cents before the loan was applied for.

LOS ANGELES LUMBER PRODUCTS COMPANY CASE.

Next, I come to the Los Angeles Lumber Products Company Case, which I want to speak on for a minute. Of course, we think that there are obvious distinctions between Chapter 9, which is a composition statute, and Section 77-B, which is a reorganization statute. That distinction is inherent in the terms. Composition is necessarily a cutting down, or scale down; reorganization is something quite different[5]. Mr. Justice Douglas,

5. Composition is a voluntary proceeding by which the debtor offers to pay his creditors a certain sum in exchange for a release and the amount offered may be even less than would be realized through distribution in bankruptcy. (*Cumberland Glass Mfg. Co. v. DeWitt*, 237 U. S. 447 at 452, 59 L. Ed. 1042 at 1045, 35 S. Ct. 636; *Nassau Smelting and Refining Works, Ltd. v. Brightwood Bronze Foundry Co.*, 265 U. S. 267 at 270, 68 L. Ed. 1013 at 1015, 44 S. Ct. 506.) The purpose is to enforce the will of the majority upon the minority and "except for this coercion * * * the intervention of a court of bankruptcy would hardly be necessary." (*Samuel A. Myers v. International Trust Co.* 273 U. S. 380, 71 L. Ed. 692 at 697, 47 S. Ct. 372 at 374.)

in the Los Angeles Case, in a footnote—which your Honors undoubtedly have read—calls attention to the fact that Section 77-B is not a composition statute at all, and reference is made to the fact that in 77-B the word "composition" does not appear. Conversely, if you turn to Chapter 9, you will find it is all composition, and the word "reorganization" does not appear. In Mr. Justice Hughes' Opinion in the *Bekins* Case, he stresses the composition feature of the Municipal Bankruptcy Act, and significantly, as we point out in our brief, the Supreme Court, on the very day it handed down the Los Angeles decision, denied certiorari in the case of *Luehrmann v. Drainage District No. 7,* 104 Fed. (2d) 696, which came up under the composition statute. In the *Luehrmann* Case, the scale-down as I remember, was from some hundred cents to 25 cents, and the only evidence, as you read the opinion, of fairness of the plan was the consent and the appreciation in value of the bonds. That was the first important—perhaps the only outstanding case involving the questions which we have before this Court to go to the United States Supreme Court in a way which would have called for a ruling on the legal principles relating to composition, had there been any basis for the contention that the composition statute is identical with Section 77-B.

Of course, however, we feel that even if the *Los Angeles* Case were applied in this case, so far as it is possible to apply the case to a different set-up, that we are still entitled—clearly entitled to an affirmance of this plan. Of course, when you start with the assumption that the creditors in a private corporation, as they are, are en-

titled to foreclose their obligations, to sell the assets, to reduce them to money and to divide up what is realized, it seems to follow that you can't cut the stockholders in until the creditors are paid. But we deal here with an entirely different agency. There is no right to take any of our property. If they did take it, they wouldn't know what to do with it, I am sure of that. The irrigation system has no value unless landowners who use it can farm their lands profitably.

Judge Denman. Wouldn't the Districts in which all the land has been bought in hold in trust for the bondholders?

Mr. Downey. Well, our Supreme Court held in the case of *El Camino Irr. Dist. v. El Camino Ld. Corp.*, 12 Cal. (2d) 378, 85 P. (2d) 123, that after the District had acquired the property it still could not be taken on execution by the bondholders, and in *Clough v. Compton-Delevan Irr. Dist.*, 12 Cal. (2) 385, 85 P. (2) 126, it held that the lands could not be partitioned. The Supreme Court certainly held that the land was held in trust but not alone for the bondholders. It held that the land was in trust for all the purposes of the Irrigation District Act, including operation of the district and payment to bondholders. In effect, the Court held that the only thing bondholders could get out of the property was the rentals after the amount required for operation had been taken out.

Judge Denman. Then your argument is that that might very well be worth less to the bondholders than the 51 per cent?

Mr. Downey. Unquestionably, that is true.

Judge Denman. But you can't get the analogy between that and a bond which is a lien directly upon the property, and you can't foreclose directly as you can in the street assessment districts.

Mr. Downey. Not only that, your Honor, but we must bear in mind that all of these irrigation district lands are also subject to other public obligations. They are subject to taxes, and they are often subject to improvement district liens of one kind or another, so what actually happens in practice is that whenever the *lands* begin to go delinquent, they probably default not only in the irrigation assessments but in their taxes, and other obligations. We have agencies that have four or five or six tax titles. The property will be deeded to the State for delinquent taxes; property will be deeded to a reclamation district for delinquent reclamation assessments, and to the irrigation district for delinquent irrigation assessments; and we get into a mess that is well-nigh impossible to unscramble.

Judge Denman. Let's see if I can follow you in my mind. Your answer to the statement of your opponent that because the value of the land is greater than the value of the 51 cents, therefore there ought to be a higher amount, and this is unfair because of that, your answer is that they have no lien on the land; that when you determine the value of the land it is not its free value, but its value as impaired by other tax liens and tax obligations, and when you come to view it from that standpoint, the court was within its discretion in deciding that it was less than the 51 cents. Is that the summary of your argument?

Mr. Downey. That is correct, your Honor; it doesn't go quite as far as I go, but that is one point upon which I rely.

Judge Denman. How much further do you go?

Mr. Downey. I go this much further: that it is utterly impossible to have market value in an irrigation district which is encumbered by a bond issue in excess of the ability of the lands to pay.

Judge Denman. This assumes cleaning up and taking over the land. The question as presented by your opponents is: assuming now that it is cleaned up, so far as the processes of the irrigation district may do so, will it at the end of that time be worth more than 51 cents to these people? You can't have your cake and eat it, too. You can't say this thing is going to remain there. If you clean it up and the lien no longer remains, will what you get out of it be worth more than 51 cents? I have tried to summarize what they say.

Mr. Downey. I think that is a fair summary, your Honor, except the converse is also true: once you put the district on an ability-to-pay basis, then your lands have value. According to the Cone report they are worth about $10,000,000 (Ex. 35, p. 128). Once you exceed the ability to pay, they don't have any value; so, I say to your Honors, in an irrigation district, the question to be determined is: what is the ability to pay? We will concede that we must offer in court a plan which is based on ability to pay. If we do that, then all of the other factors go out of the case.

Judge Denman. Suppose somebody suggested a plan on the basis of ability to pay——

Mr. Downey. Yes, your Honor.

Judge Denman (continuing). What you have got to do is to show that your plan is the best that can be taken, stretching your ability to pay to the limit. That is your position, Mr. Downey?

Mr. Downey. I think that is a fair statement of it, your Honor, and that is what we have attempted to do here. Of course, let me say this: that no two persons, no two bankers, no two underwriters would ever agree to the cent as to what any irrigation district would pay. There is no exact yardstick to determine ability to pay. And in the last analysis it must rest upon a finding that the plan is fair. The exact quantum is impossible to ascertain. It is an inference of fact drawn by the trial judge.

Judge Denman. That is the reason I tried to get your opponent to state what he thought the character of the evidence was; whether the evidence presented to the lower court an area in which it had a discretionary judgment as to values. I am not quite certain what their position was on that.

Mr. Downey. I am sure I don't know, your Honor. They said—these were their words: the "finding on fairness disappeared" from this case for some reason. And they said that the finding was entitled to a "mere presumption" of fairness. That this proceeding here is a "trial *de novo*" on fairness.

FINDINGS STAND UNLESS CLEARLY ERRONEOUS.

Now, may it please your Honors, this court in the past few months has decided in at least four recent cases

(*Anglo California National Bank of San Francisco v. Lazard et al.*, 106 F. (2d) 693; *Western Union Telegraph Co. v. Nester*, 106 F. (2d) 587; *Cherry-Burrell Co. et al. v. Thatcher*, 107 Fed. (2d) 65 and *Occidental Life Insurance Company v. Thomas*, 107 F. (2d) 876) that under Section 52 of the new Rules of Civil Procedure the findings of the trial court stand unless they are clearly erroneous. And that if different inferences may be drawn from the testimony, the inference drawn by the trial court will be upheld unless no reasonable man could draw such inference. And it has held that this court will not weigh the evidence. The weight of evidence is for the trial judge. And going back a little further, I remember a case in which Judge Wilbur said, in effect, that the findings of the trial court are conclusive if there is any evidence to sustain them "it matters not how convincing the argument that upon the evidence the findings should have been different" (*Ocean Accident & Guaranty Corporation v. Ethel Rubin, et al.*, 73 F. (2d) 157).[6]

We have a finding here—and I might state to your Honors that aside from the legal points, it seemed to me the argument of counsel for appellants was simply an argument on the facts, and if you will turn to the briefs you will find it is only in the closing brief of appellants that they really go into the question of fairness in detail.

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6. Even if incompetent evidence is considered by a trial court, the question still is: is the evidence sufficient to support the findings eliminating the incompetent evidence? (*National Ben-Franklin Insurance Company v. Stuckey*, 86 Fed. (2d) 175, at 176; *United States v. Blumenthal*, 77 Fed. (2d) 219 at 221. In the notes of the Advisory Committee on the new rules of Civil Procedure, speaking of Rule 52 and the provision that findings of fact shall not be set aside unless clearly erroneous, the Committee says: "* * * It is applicable to all classes of findings in cases tried without a jury whether the finding is of a fact concerning which there was conflict of testimony, or of a fact deduced or inferred from uncontradicted testimony." (U.S.C.A. Title 28 under authority of Secs. 723b and 723c.)

I don't mean unfairness is not suggested, but really, the closing brief of appellants is the first time they undertake to point out in detail what they think the district could pay, and they first say $14,500,000, then they get so enthusiastic that they say "You should pay $20,000,000, notwithstanding you went into utter collapse at $16,-000,000". It would have seemed that if this plan were unfair, if we were not paying what the district was able to pay, they would have shown in the testimony that this underwriter or this bank or this group would be glad to finance that district at an amount in excess of $8,000,000; not a word of that kind is in the evidence. As a matter of fact, your Honors, the evidence of fairness in this case rests almost entirely upon our testimony. I don't know what they put in that tended to show the plan was unfair. There is an analysis of the plan in their closing brief and of our revenue and income that I want to take up. It is really this analysis of our income in their closing brief, and here, and of the Benedict report in their closing brief, and here, upon which their position rests.

POWER REVENUE—$400,000 NET.

Now, this district does have a substantial power income. If it did not have, we would not have received 50 cents from the R. F. C., and, as I said a little earlier, we tried to—we contended there that we could get $500,000 a year from our power. However, based on our experience, it doesn't hold up. If we take the run-off records of the Merced River going back to 1872 and figure out theoretically, if that water had been run through our power plant

in those years, what it would have produced—the engineers get a figure somewhere around $500,000.[7] Based on actual experience, we find that we don't get that. The district has been operating the power plant since 1926, and, based on the actual yield we gross $444,000 a year (R. 407). Now, again that we have operation expenses at the power plant, amounting to about $22,000 annually (R. 407) and there is a depreciation—and it is a very real depreciation, not a bookkeeping depreciation, on the plant of about $22,000 more (R. 408); so that conservatively, we have to estimate our net power yield at $400,000.

Now, Mr. Childers said, "Well, it is uncontradicted that, based on the run-off of the past you should get $500,000"—or whatever the figure was. They contend it is in excess of $500,000. Well, it is one thing to operate a power plant faced with the problems that the operator has to face every day, and it is another thing to work it out on paper. It is like the Monday morning quarterback diagnosing the plays that should have been made on the preceding Saturday. Right today we have a substantial amount of water in our reservoir as a result of the recent rains. We also know to some extent what the snow conditions are in the mountains, but we can't know that very accurately. Now, should we open our plant today, or not? Well, your operator has to decide whether if he starts the plant running today he is taking a chance—if we run into a dry period the next two or three months—of coming to the irrigation season without any water.

7. Thebo, Starr and Anderton made a report for the bondholders in April or May, 1931, indicating power revenue of $500,000 per year. Before August they revised that figure to $450,000 per year gross (R. 496).

Now, if he does not do it, there may be a big spill later on, and there will be water wasted that we could have run through the plant. On the other hand, if the operator starts his plant and we don't get the water that is expected, then we face the calamity of running through the irrigation season without any water. Again there may be lots of snow in the mountains and we may get a week of warm rain and it all may come down at once and a lot of it therefore spilled and wasted. Run-off enters into the problem and time of storms and temperature and many other things. Here is the laughable thing about this situation: Appellants call two outstanding engineers, splendid men, high-standing men, Mr. Heinze and Mr. Hill. They both testify they have gone over these run-off records and that we can get $500,000. Mr. Hill, however, in 1924 had made a report on the power income the district could expect to get at a time when bonds were being sold and prospective bondholders and landowners were vitally concerned with power income. In his report made in 1924 Mr. Hill found, based on the run-off records of the past, that the district power income under no circumstances would ever go below $300,000 a year (R. 536-538). Well, as a matter of fact since 1923, we have had three years that have been under $300,000 (1929-1931-1934, R. 671-676) and one year when we only made $95,000. That is the difference between the theoretical concept and the reality.

Now, the court held that the yield in the last two years preceding the trial was—I think he used the term "providential". It was providential. We had a yield over $700,000 in 1938, and something over $600,000 in

1937. Obviously the trial judge placed the income so far as power was concerned on an actual yield basis.

Judge Stephens. Mr. Downey, are you speaking of net return or gross?

Mr. Downey. When I say $400,000 I mean net; the gross return is $444,000.

Judge Stephens. You just said something about 700.

Mr. Downey. Well, that is gross, your Honor.

Judge Stephens. And the percentage, of course, would be about the same.

Mr. Downey. No, I think the operation cost is about the same.

Judge Denman. There is no variation in your overhead on that?

Mr. Downey. Very little, I would say; practically none.

OPERATION AND MAINTENANCE—$500,000.

Now, we start with an assured income of $400,000 net power, let us say, according to our figures, then we have to operate. Now, the testimony on operation and maintenance was this—not contradicted—that ordinary operation and maintenance is $375,000 a year (R. 513). If we actually carry out the deferred maintenance and the capital expenditures that are absolutely imperative in the district, it is $125,000 more, or $500,000 a year (R. 513). Now, we have this picture down there: You get more money, we will say, from the power. That means more water. You run into high water conditions. The ground water rises; we have to open our channels to run the water out; we have to install drainage wells to take care

of the water, and it does not by any means follow because you are getting more power that you are actually getting more net money. I am not speaking of power house operation, but the general operation, the control of floods, the control of ground water.

Judge Denman. Are your facilities for disposing of your drainage permanent or temporary? When the occasion arises, such as a flood, have you got some pumps as a permanent installation?

Mr. Downey. We have practically no flood protection there at all. We do have protection to a certain extent against the seepage from our canals. We try to line our canals but we have not been able to do that to the extent we should. It is a progressive policy of lining we are pursuing. There are many canals which we have not been able to line, and which we have got to line otherwise the damage done by the canals, by seepage, will result in tremendous loss; then we have tried to control the ground water by drainage pumps, and we have not been able to put in enough of them. In other words, the conditions so far as control of water is concerned have to a large extent been deferred, because we have not had the money to spend. We have been operating practically as a bankrupt for six or seven years, and we are vitally in need, not merely we, but our bondholders, because they don't get anything if we don't get anything. We are vitally in need of capital improvements, and deferred maintenance money —this is the only testimony in the case: $500,000. So that, so far as the power income is concerned, on our figures, we still need $100,000 to meet operation. If we took all of the power on their figures we would be about even.

ASSESSMENT YIELD AT $4.00 PER HUNDRED. NO DELINQUENCY—$480,000.

Now, then, what is the situation with respect to assessments? We have been levying $3 a hundred—it is not an acre charge—they speak of it as $1.75 an acre average which is very deceptive. It is $3 a hundred. We can't figure these things on *flats*. $3 a hundred is the emergency rate we have been levying. If we could restore all of our land to the tax roll we would have about $12,000,000, according to our books, and if we levy a $4 rate —remember, we have not been servicing a portion of our bonds, because they have been tied up in this litigation or some similar litigation—if we could get every dollar of land back on the tax roll 100% and if we levied a $4 rate, that would bring us in, if there wasn't any delinquency at all, $480,000 a year. Taking our figures, $400,000 on power, and a $4 tax rate, $480,000, without a penny of delinquency, we should have a total income of $880,000.

SERVICE OF R. F. C. BONDS—$435,000.

Now, to service the bond issue to the R. F. C. costs $435,000 annually after all dissenting bonds are in. If all these bonds were in and the R. F. C. took our refunding bonds, the service charge would be $435,000 a year. So that, taking the $435,000, plus $500,000 for maintenance, we get $935,000 that we are required to meet annually as against the income of $880,000 on a $4 tax rate.

Whether we will be able to operate on a $4 tax rate successfully—we don't know; there is a slight margain there; we may have to go a little above; we hope to go

a little below; we should, in order to compete successfully, and to really carry our bond issue, have about a $3 tax rate, which is about the rate of the two districts that I spoke of this morning, Turlock and Modesto, which are directly in competition with us. Remember, we have got to subdivide; we have got to colonize; we have got to sell our lands, and we can't sell our lands if Turlock, immediately adjoining us, and Modesto, immediately adjoining Turlock, are offering the same grade of lands, the same type of crop, and only paying a tax rate of $3, while we have to pay $4, $5, $6, $7 or $8—that aside from the question of ability to pay. There has been no real development or subdivision in the District since its formation.

Judge Denman. You don't want us to consider the question, do you, whether or not it is unfair to the landowner because 51 is too high?

Mr. Downey. Your Honor, that same question was asked Dr. Benedict in 1936 when he was on the stand. I remember Judge Cosgrave asked him that question, and this is what he said—this is the record, page 471:

> "Had this survey been made back in 1919"—I interpolate there the remark that at that time the Agricultural Index was over 200. Now I am quoting from Dr. Benedict—"and the survey showed that it did at this other time, I would feel that the formation of this district of improvements, the building of the dam, the storage of the water, was an impractical proposition. It is true, I think, that costs are being somewhat reduced from what they were in the period when this survey was made. Costs move somewhat more slowly than prices of products do. *It will depend upon this condition whether or not the new bonds"*—that is the R. F. C. bonds—*"will be as much a failure as the old ones."*

And Dr. Benedict also said in 1936:

"If general economic and farming conditions come back, in fairly good condition in the next few years, I still would not expect these large holdings to be broken up more or less, and additional development take place in this District, because there has been a very pronounced change in the general situation affecting a great many of the California specialty crops and many of the major fruits of the United States, growing out of, in large part, a sharply reversed world situation. Many of these products depend to some extent on export markets, and those markets have been very sharply curtailed in recent years, and there is no present indication of very much improvement for a considerable time to come (R. 462).

All business, including agriculture, has improved somewhat since 1933. If we assume that agriculture and other business conditions come back to a condition similar to 1910-1914, or any other period, we may select, materially above what it is now, many of the indications of my report would still apply. The best estimates that the United States Department of Agriculture has been able to make are that, without some form of curtailment in many lines of production, that we must squeeze out of production variously estimated amounts of land—from 25 to 50 million acres in the United States; that is bound to be a depressing influence for a very considerable time, possibly 10 to 20 years, if that is the procedure with results. The agricultural adjustment program was, of course, designed to ease that transition. That has been eliminated for the present, at least. What future developments will be is very difficult to determine at this time.

It is my opinion there is no prospect of a sharp rise in agricultural prices. By a sharp rise I mean

> such an increase as we had during the period from 1915 to 1919; during war conditions. I would expect a rise equal to the 1930 prices. I do not think it would go above that."

I have to refer repeatedly in this argument to the Benedict Report because appellants in their reply brief, for the first time, made an attack upon that report.

I assure your Honors that the R. F. C., in my judgment, made a loan here which no private banker and no private underwriter would have done. I think we can pay out, your Honors, but the margin of safety is not great. I know too much about the danger of hitting a tax rate that gets a little high; it results in a delinquency. You have to levy a higher tax the next year to make up that delinquency, and your assessments begin to pile up, and up, and up, until they reach a point where nobody can pay; and I cite in my brief a situation in the Acquisition and Improvement District No. 36 in San Diego County where this year they now have a tax rate, by a process of pyramiding delinquencies, of $28,000 per hundred dollars of assessed valuation. In other words, if land had an assessed valuation of $10,000 it would be assessed $28,000,000. This sort of thing inevitably happens, perhaps not on as fantastic a scale as that, once a point is reached where the ability to pay is exceeded.

Now, taking the income as contended for by appellants in their reply brief which they assert could carry a bond issue of $14,000,000, their power income is $100,000 too high, based on this theoretical study rather than actual yield; their operation is $100,000 too little, because they are taking the actual operation for the last few years

as against the fact that the record shows we will have to spend $500,000; and then they pick up $100,000 a year in the tax redemptions. I called your Honors' attention to that when I read the bondholders' committee letter to you, that at that time there was over a million dollars in delinquencies. It is that money which has been coming in in the last four or five years, based undoubtedly on fresh loans and new encouragement, together with the high power yield, which has given us a favorable showing today. Appellants count the hundred thousand dollars a year coming in, but that money doesn't come in both as a tax and as a delinquency; you don't make more money out of it by calling it a delinquent tax or a redemption. My figures are predicated upon the assumption that we have a $4 tax rate, and every acre pays—there isn't a cent of delinquency—at a $4 tax rate, that will bring us in $480,000. Now, the money that has come in on redemptions is largely past. There is still some delinquent money that we hope to get in, but if this plan goes through our plan is to try immediately to get all of the balance of the land restored to the assessment roll. We want, with the consent of the R. F. C., to exclude a lot of land where the service is at a loss, and if we do that and are able to hold a $4 tax rate, and if we can carry a $4 tax rate, and we don't run into a long period of drought on our power, or floods or breakdowns in our plant we will get along; but to talk about this District servicing $14,000,000 is just about as sensible as talking about servicing $20,000,000, and counsel conceded that because, having worked it out with pencil and a piece of paper at fourteen million, they say, "Why not twenty

million?''. Notwithstanding what the experience of the past has shown.

Now, one thing that may be effective in this argument on the facts from the other side—in their reply brief they say your Honors have the record before you in the *Palo Verde* Case. They say: In Palo Verde the better lands are going to pay $5.50 per hundred. ''Well,'' they say, ''look at Palo Verde. That isn't half as good as Merced. They figure ours at $1.75 an acre, we can't figure it on an acreage basis.'' It is fallacious to do so. They say, ''It can't be fair''—the Merced rate.

Now, if your Honors please, there isn't a syllable of testimony in the Merced record on Palo Verde or any other district, except Turlock and Modesto, which are competitors. In the second place, if you were to make a comparison between districts it would have to be done with the most careful analysis. You can't compare a district down near San Diego and on the Arizona border with a district up in the San Joaquin Valley; there are too many variables. First, the question of climate, growing season, and *crop* yield. I understand, for example, in Palo Verde they have a lot of alfalfa, and a much longer growing season; they probably have several more cuttings than we do in alfalfa alone. You have to go into the question of prices on specialty crops, what are the labor costs and what are the material costs, and what is the proximity to market, and all that sort of thing. There are probably a dozen or more essential variables in connection with these irrigation districts, and not only do I consider it unfair, in their closing brief, to bring up a case like that, that we have never even had a chance to cross-examine

witnesses about—with respect to which there is not a single syllable of testimony—but, obviously, you can't compare those kinds of districts, and it should not be put forward by counsel as ground for the contention that it has any bearing on the Merced District.

Some similar remark was made about the Corcoran District, and the Lindsay-Strathmore, which is a citrus district. So, it comes to this: Every district has its own problems. It is a question of yields and water service, and all the other things which necessarily enter into the question of cost and ability to pay.

Now, your Honors, I have been talking a long time. I thought if I worked over this I would be able to cut it down. I would like to address myself very briefly to the question of the R. F. C. status, and Section 52. Mr. Shaw and Mr. Knupp will wish to talk, and they are going to talk particularly on the jurisdictional questions advanced by Mr. Childers, and also on these others—I think in a few minutes perhaps I can cover those two points, but I find that I take longer than I hope to.

STATUS OF R. F. C.

Now, first, on the status of the R. F. C., we start with the principle that in composition cases the debtor can go out and borrow money on his own terms and use his security to effect a composition. *Zavelo v. Reeves,* 227 U. S. 625, 33 Sup. Ct. 365, 57 L. Ed. 676, cited in my brief, and decided by the United States Supreme Court, establishes that. And there is no contention that under

the law of California we don't have the right to borrow money to refinance our debt.

Judge Mathews. What is the name of the case you just cited?

Mr. Downey. *Zavelo v. Reeves;* it is cited in my brief, your Honor (spelling) Z-a-v-e-l-o.

Judge Mathews. I have it.

Mr. Downey. Now, in our brief we show that every contract made with the R. F. C.—there are two of them, one in September, 1935 (Ex. OO, p. 202) and one in August of 1935 (Ex. OO, p. 217)—and every resolution passed by the R. F. C. and accepted by our district, expressly stipulated that the old bonds should be maintained alive as outstanding obligations in order to assure parity and for other purposes. Now, in the reply brief it is suggested for the first time that the controlling contract is the contract of September 16, 1935. That is Exhibit 8; it is in Exhibit "OO", page 202. That is the last contract. The first resolution was November, 1934 (Ex. OO, p. 155), authorizing the loan, then in August, 1935, just before the disbursement, there is a contract which we think is intended to cover the disbursement, itself (Ex. OO, p. 217), and then in September there is a contract for the purchase of the refunding bonds (Ex. OO, p. 202). Now, it is asserted dogmatically in the reply brief, first, that this contract of September 16, 1935 throws the August contract out of the picture, as a later contract, and, secondly, that in this contract of September 16, 1935, the R. F. C. gives a firm agreement to purchase up to $8,600,000 of refunding bonds and to turn in the old bonds at $51.50—that is the settlement rate.

Now, that is wrong on every count. In the first place, all of these contracts have to be considered together. They are practically contemporaneous documents. But, passing that point, if we take this agreement of September 16, 1935 and stand on it alone, this is what we find: First, in paragraph 10, it is expressly provided that the R. F. C. must be—and I quote—

> "satisfied as to all legal matters and proceedings affecting the bonds and the security thereof, otherwise the R. F. C. shall not be under obligation to purchase any of said bonds".

There is a clause which provides that the old bonds are to continue as outstanding obligations; there is a clause which provides that the district is required to carry out the obligations which it assumed upon its acceptance of the original resolution of November 14, 1934, and if we turn back to that resolution, your Honors, to find out what the situation is, we find it stated over and over again that the district is obligated to service the old bonds, to regard them as outstanding for the full face amount thereof. Now appellants say that under the last contract (Ex. OO, p. 202) the R. F. C. is obligated to turn in the old bonds, no matter how many of them they have, at $51.50. But if we turn to the resolution of November 14, 1934, which is incorporated in that contract, we find this: I am reading from page 163, "OO":

> "The Division Chief * * * may require the borrower to duly execute or agree to execute such amount of its new 4 per cent bonds as they may specify, and when executed, to deliver such bonds to a trustee or custodian * * *"

Such trustee shall be—I quote—

> "irrevocably bound to exchange new bonds for a like or greater principal amount of the old securities".

In other words, the R. F. C. could say to us, "You give us eight million dollars of refunding bonds, under that clause, and we will give you eight million dollars of old bonds", which leaves still the differential of eight million dollars in their favor. These provisions are necessary to insure parity.

Now, may it please the Court, I have gone over these documents again, and again, and again, and discussed them. We have all discussed them. The R. F. C. has discussed them with us; and this contract is perfectly plain, if we just take the contract. The difficulty comes here from attaching some kind of a label to it and then trying, as I said in my brief, to pour it into some kind of a legal mold; but the contract, itself, is clear. This is all it is: The R. F. C. says to us: We will loan you $8,600,000 to refinance your debt. Now, you are to go ahead and to get your securities available for refinancing. "When we get ready—good and ready—when we are satisfied, we will buy your refunding bonds, and then we will make the exchange. Now, in the meantime we will go out and buy up those bonds and hold them". There is nothing wrong in that; anybody, any of these appellants, could have gone out and bought up district bonds at that figure, or any other figure. They could have gotten them at less and held them. They are not hurt by that; and not only do the cases cited in our brief say this is a common situation in reorganization proceedings, but they go far beyond——

Judge Denman (interrupting). Are you now arguing that there is not a loan to the district for the purpose of enabling the district to buy the bonds in?

Mr. Downey. No, not to enable the district to buy in the bonds; it is loaned to the district on condition that it will make available its securities for refinancing and insure parity.

Judge Denman. Do you or don't you contend or admit and agree that the R. F. C. is the agent of its borrower in procuring the securities for the purpose of the whole refinancing?

Mr. Downey. I don't think it is the agent of the district, your Honor.

Judge Denman. Whose funds are there on deposit that are paid out for these bonds?

Mr. Downey. The R. F. C. has merely authorized the Federal Reserve Bank to buy for its account any bonds of the Merced Irrigation District which are presented at the price of $51.50. That is all there is, so far as the R. F. C. and the Federal Reserve Bank are concerned.

Judge Denman. I mean as between the district and the R. F. C., is it your contention that the money is not borrowed, at all? That they don't owe anything, or is it your contention the money has been borrowed and you are paying interest on it, and it has been used to buy in the bonds for your account? If you have not borrowed the money, if the R. F. C. is simply buying these for themselves, how are you going to pay all this interest?

Mr. Downey. We have agreed with the R. F. C. that if they will buy up our bonds and make them available for refinancing we will pay them 4 per cent on that price, with the understanding that when they have bought up

all of our bonds or we have brought them in to them so they can buy them up, they will then exchange those bonds for our refunding bonds. It is an interim arrangement at the present time.

Judge Denman. You don't think, then, that the bonds that are surrendered are going to be surrendered in cancellation of the existing debt?

Mr. Downey. They certainly are not at the present time, your Honor. Not until refinancing is complete.

Judge Denman. I mean those surrendered now. When the old bonds are surrendered, do you not expect a settlement then of the loan that has been going on in the interim, in the form of a new bond?

Mr. Downey. Most assuredly, when it is completed.

Judge Mathews. What is the amount of this loan?

Mr. Downey. The amount used by the R. F. C. to buy up the bonds is approximately $7,500,000, with which they purchased nearly $15,000,000 in bonds.

Judge Denman. You say your position is that the R. F. C., as an independent entrepreneur, is going to buy up a lot of bonds when the district says, "We will pay you interest on the amount you spend to buy up our bonds, and after it is all over and they are all in, then we will convert this thing into a sale of bonds to *us*." Is that the position you take?

Mr. Downey. Your Honor, that is a perfectly proper position.

Judge Denman. How do you get all those words of "loan" all the way through the transaction?

Mr. Downey. It is a conditional loan; the conditions have not been complied with. Yes, your Honor, if I understand you now there isn't any question but that

subject to certain conditions the R. F. C. has made a loan. Now, those conditions are not complied with until after we have made available the old securities for refinancing, or until the R. F. C.——

Judge Denman (interrupting). Suppose you don't do that? Suppose you don't do that? Don't you owe them any money? If you don't carry out all those conditions, don't you owe them any money?

Mr. Downey. They naturally could enforce the bonds and get back the amount they have used to purchase the bonds, but, on the other hand, we couldn't go to the R. F. C. tomorrow and demand that they accept our refunding bonds. We couldn't go to the R. F. C. and say, "Our refinancing is complete, and we demand of you today that you give us the old bonds and we will give you the refunding bonds".We wouldn't get anywhere on that basis, because there is nothing in the contract which obligates the R. F. C. to take our refunding bonds until they are satisfied that the refinancing is complete.

Judge Denman. The R. F. C. is not going to take a lot of new bonds with the prior issue outstanding. What they want to do is what anyone would do, to have a perfectly clean single obligation in the new bonds. But isn't that what is really said in that last contract?

Mr. Downey. Well, I think that is, your Honor.

Judge Denman. I mean to say: I am not willing to accept a second bond issue with everything outstanding prior to it. The last contract refers to that. They want to know what any lender would want to know: that there is nothing outstanding in the way of a prior lien; but I had difficulty in following your argument that you were not borrowing any money at the present time.

Mr. Downey. I say we have had a loan on condition, the conditions of which have not been fulfilled,——

Judge Mathews (interrupting). You can't postpone a contract to make a loan; but your contract is not yet an executed contract.

Mr. Downey. That is correct.

Judge Stephens. The district has not received any money it could use as yet?

Mr. Downey. That is correct.

Judge Denman. Then all this money you have been paying is by way of an option, and all the interest money is interest on the loan which is represented by the option to do something in the future, according to your theory?

Mr. Downey. Your Honor, it is paid because it is for the benefit of the district to pay it. That is to say, the R. F. C. says to us, "We will go out and buy up these bonds, but you have got to pay us 4 per cent on the amount we use for that purpose". Now, we are benefited by that.

Judge Stephens. How?

Mr. Downey. Well, we are benefited because it is an essential element in the consummation of the plan that they should do it that way. We haven't got the money to do it, ourselves; we have no money.

Judge Stephens. How does that cut down on the total debt?

Mr. Downey. It doesn't cut down on the total debt until such time as they have been able to buy them all in.

Judge Stephens. How does that operate? I thought I understood it, but I have become a little confused the last few minutes.

Mr. Downey. The 4 per cent that the district pays, it pays for the benefit that accrues to it in having the R. F. C. buy the bonds. Now, if we don't consummate this transaction, we believe under the contract that the 4 per cent would then be credited against the interest on the bonds which the R. F. C. holds.

Judge Stephens. If this doesn't go through, you will pay out twice as much?

Mr. Downey. That is correct. We throw ourselves on the mercy of the R. F. C.

Judge Mathews. This 4 per cent is not at the present time regarded as bond interest, but is the stipulated interest on the amounts the R. F. C. has advanced or used to purchase the bonds with?

Mr. Downey. That is correct.

Judge Mathews (continuing). Which is less than the bond interest would be?

Mr. Downey. That is correct. They could collect bond interest, but they have stipulated they won't. The 4 per cent is for the use of new money poured into a bankrupt district.

Judge Mathews. When you speak of the amount due on a loan, you mean the amount so far invested by the R. F. C. in these old bonds?

Mr. Downey. That is right.

Judge Stephens. But you are paying 4 per cent on the bonds the R. F. C. has taken up, and nothing on the other old bonds?

Mr. Downey. That is correct, your Honor. We are paying 4 per cent on the money advanced by the R. F. C. to buy the bonds.

Judge Denman. Frankly, I don't agree with you, at all. My conception of that thing is that what they have done is just what they said they did. That is to say: I have some money; I will lend it to you, and as your agent I will buy some bonds in, and when it reaches a certain point I will stop and I will turn them all over to you—I will not hold them as security; I will turn them all over to you and take some new bonds. That is the way that contract looks to me, to be perfectly frank with you; it seems to me it is the ordinary business transaction, that the maintenance of the parity, if it is done, is just what is customarily done, and that those bonds have a parity of interest in this proceeding. But I can't see it as an agreement in which—for an option or a future acquisition of the bonds, if you have been paying this interest all this time. I can't see anything in it except paying interest on a debt—a loan which the lender has made to you or put in the bank, or left credit in the bank—if it has bought for you some bonds. I say this so you will get my own viewpoint on it. Each one of us has got to have a conviction about your case, but it seems to me, as I see it now, that if you can show that there is a proper agreement for the maintenance of parity customary in such refunding transactions, that you convince me on this end of your case, but not on the basis of being an option on which you pay an interest rate monthly.

Mr. Downey. I didn't intend to call it an option, your Honor.

Judge Denman. It is either an option or a loan. If you are buying the contract or paying a monthly amount of consideration for a future contract, it is interest on a loan.

Mr. Downey. I wouldn't attempt to take opposition to your Honor's statement; I think it is substantially correct. It seems to me that such difference, if there is any here, is a difference in the minutiae of the thing; that I don't perhaps follow, or perhaps your Honor does not follow me, which I don't wonder at under the circumstances. I venture this assertion: that anybody who picks up that resolution of November 14, 1934 and those two contracts, and then considers the transaction at the time the money was actually disbursed, when the R. F. C. took bills of sale to those bonds, would come to one conclusion. That is, that the bonds are outstanding and provable in this case, and they are here for the purpose of establishing parity among all the bondholders. Mr. Shaw and Mr. Knupp were going to talk further about this point. I wanted to talk very briefly about Section 52; that is the *Bates v. McHenry* rule. I think I can cover it in seven minutes.

Judge Denman. Go ahead.

SECTION 52 AND BATES v. McHENRY.

Mr. Downey. This is the contention of our opponents on Section 52, *Bates v. McHenry:* They say that that case —*Bates v. McHenry,* 123 Cal. App. 81, 10 Pac. (2d) 1038, held that the bondholders should be paid in the order of their presentation; that they have some kind of a preferred right or lien, if they are such registered bondholders, to the extent anyway that there is money in the fund—in the case of the Merced Irrigation District, there is a million five hundred thousand dollars there.

And they claim that the bondholders who first presented their bonds for payment and had them registered, would be entitled to have all of that million and a half dollars, leaving the other bondholders to get what they could, if anything. They say that is the rule of *Bates v. McHenry;* and if you follow through that case, you do find that the Supreme Court has said over and over again that the bondholders in an irrigation district are entitled to be paid in the order of their presentation; it sounds plausible. However, *Bates v. McHenry* undoubtedly construes Section 52 of the Irrigation District Act, providing for the payments, as merely establishing an orderly procedure of payment and putting all bondholders on a parity in a solvent district because the basis of that decision is that the bondholder who comes in and gets the money gets cash, and the bondholder who can't get money because the fund is temporarily exhausted, registers his bond and gets 7 per cent interest. One gets the cash immediately and the other gets the cash in time plus 7 per cent for the deferred period. In other words, the statute obviously contemplates a solvent district, and the rule is merely one of orderly disbursement in such solvent district. It is a rule of parity and equal treatment among all bondholders.

Now the *Merced* District, at that time was not regarded as insolvent, at least the question of bankruptcy was not involved, and as a matter of fact, it did pay the money, so that all bondholders got their money for that particular interest date. Mr. Justice Plummer, in that opinion, points out that there is a clear distinction between the provisions for payment of bonds and interest coupons

under the Irrigation District Laws of the State, and the marshaling of assets to make payment on the bonds of an insolvent concern or where there is only one fund out of which payment can be made. Bankruptcy or insolvency of the irrigation district would therefore raise entirely different considerations. Following the *Bates v. McHenry* case we have *Selby v. Oakdale Irrigation District,* 140 Cal. App. 171, 35 P. (2d) 125, which Mr. Cook referred to yesterday, where again the rule was invoked by the court not to *give* a preference—as appellants contend should be given—but to *prevent* a preference. There, the Oakdale District had levied a tax to service its refunding bonds, and had attempted to pay them off to the exclusion of the old bonds. Mr. Justice Plummer says you can't do that; you have to pay in the order of presentation to prevent a preference. There was no question of bankruptcy there. Why should holders of the refunding bonds be favored as against the registered bondholders?

The next irrigation district case was the case cited by Mr. Cook (*Shouse v. Quinley,* 3 Cal. (2d) 357, 45 P. (2d) 701) where the legislature passed an act providing that landowners who held bonds could pay their assessments in bonds. This law was set aside on the obvious ground it impairs the contract, and because the court says it gives a preference to the landowner who is a bondholder, and that can't be done either. It says the money must be paid to the bondholders in the order of presentation. You can't give the landowner a preference over registered bondholders by permitting him to pay his assessment in bonds. If you do, he gets paid ahead of the registered bondholders.

Turning to the reclamation district cases which cite *Bates v. McHenry,* we find they proceed upon the theory that because in reclamation districts there is not an inexhaustible power of taxation as there is in irrigation districts, the fund is not replenishable and, in the event of shortage, money must be prorated. In *Rohwer v. Gibson,* 126 Cal. App. 707, 14 P. (2d) 1051, involving a reclamation district, Mr. Justice Plummer says there it is different from an irrigation district; the irrigation district fund is replenishable but the reclamation district fund is not replenishable, and, therefore, the money must be prorated in the event the fund is short. Then follows a group of reclamation district cases following *Rohwer v. Gibson,*[8] in all of which it was held the funds were to be prorated.

Now, there is a third class of cases which cite *Bates v. McHenry,* namely, the Road Improvement District cases. The Supreme Court of this State, in *Kerr Glass Manufacturing Co. v. City of San Buenaventura,* 7 Cal. (2d) 701, 62 P. (2d) 583, had a case where insufficient money had come into the fund to meet the bond obligations. There was a limited power of general taxation behind the bonds in addition to the assessment; it was not however inexhaustible. The Supreme Court in that case said the money would have to be prorated, citing the *Port of Astoria* case. In the *Port of Astoria* case (15 P. (2d) 385) the Supreme Court of Oregon held that if there is an inexhaustible power of taxation, but as a matter of fact

8. *Kimball v. Hastings Rec. Dist.,* 137 Cal. App. 687, 31 P.(2d) 417; *Cooper v. Gibson,* 133 Cal. App. 532, 24 P.(2d) 952; *River Farms Co. v. Gibson,* 4 Cal. App. (2d) 731, 42 P. (2d) 95; *Bank of Hawaii v. Gibson,* 15 Cal. App. (2d) 407, 59 P. (2d) 559.

the exercise of the power would be futile, the situation is exactly as if the fund were not replenishable. Referring to that case the Supreme Court of California says:

> "* * * The trust status of the fund has been considered appropriate where it is theoretically replenishable by a so-called inexhaustible taxing power, but the exercise of that power is rendered fruitless by reason of economic conditions resulting in a tax-collecting incapacity." (p. 710.)

Judge Denman. Just how are you going to determine that? Take those 7 per cent bonds, just at what moment do those cease to be a different kind of obligation from the 6 per cent bonds or the 5 per cent bonds and become the same? Say I have got $100,000 worth of 7 per cent of this kind, this preferential kind. I think, if I hang onto them—I would rather take my chances on the 7 per cent and let the other fellows take their chances on the 5. Why am I not in a different class? Why aren't my interests different from the 5 per cent fellows and the 6 per cent, when it comes to assenting to something?

Mr. Downey. Your Honor, it certainly is a very difficult thing to determine whether the district is bankrupt or insolvent. I concede that. Of course, in this particular case that we are talking about, the Merced case, we have insolvency——

Judge Denman (interrupting). These questions only arise in insolvency. The question is: What was the condition at the time this new 7 per cent obligation was created? It is only after insolvency comes that we have the question arising as to preference. By the way, are there any of these specially registered bonds in this case?

Mr. Downey. Yes, I think the R. F. C. holds most of the registered bonds.

Judge Denman. I thought that was in one of the others that came up.

Mr. Downey. Your Honor, if I may make myself clear, here, counsel on the other side now are contending for a rule of State law which they say is to be recognized in bankruptcy, and they contend that under the State law the bondholder who has registered his bond has a lien or preference. Now, I argue that that is not true—I am simply speaking of the State law, itself. That is not true under the State law, under Section 52 of the Bankruptcy Act, nor under the rule of *Bates v. McHenry,* and I cite the Supreme Court of California, which says that even if there is an inexhaustible *power* of taxation, if the fund cannot be replenished as a matter of fact, then——

Judge Denman (interrupting). The point I am getting at is this: As I understand your thesis, unless a taxing area is insolvent there is a difference between the registered bond and the old bond unregistered. If it is not insolvent you have the inexhaustible taxing power, but if it is insolvent, it hasn't got the inexhaustible power, because it is exhausted, or becomes exhausted in the process of using it. I say, when is the incidence of that characteristic fixed? If at the moment when the bond is registered you have not insolvency, does not its character remain the same even though it becomes insolvent subsequently?

Mr. Downey. My answer is no, your Honor.

Judge Denman. In other words, it is a bond with a preference at one moment, but something that happens in

the future changes it into a bond that has not a preference?

Mr. Downey. Yes. Only it is not a true preference. Section 52 contemplates the method of payment in a solvent district, and if at the time of payment the district is insolvent, Section 52 has no application and the registrations which have been made theretofore under that section are out. The registration which is supposed to give 7% interest has no effect if the district becomes bankrupt. Section 52 goes out of the window as soon as bankruptcy intervenes—both as to preference of payment and 7% interest. The theory of allowing 7% on the registered bonds is that the district can pay out in full and all of the provisions of Section 52 contemplate solvency.

Now, I want to say this: This precise question is up in the State Third District Court of Appeal right now, and we argued it there about two weeks ago (*Clough v. Baber*, Civil No. 6309). We contended there we were entitle to a clear enunciation of the rule from the courts of this State. I don't know when we will have a decision, but this precise point was argued. It is the only point involved.

Judge Denman. Well, we are a subordinate court to them on that point.

Mr. Downey. All of us don't agree on that. Some of the counsel with me think other questions may be involved which they wish to discuss.

In concluding this particular branch of the case I call your Honor's attention to the four cases that were decided a year ago last November, the *Provident* case and others

that counsel for appellants so firmly rely on.[9] They particularly rely on *Provident Land Corp. v. Zumwalt* in which the irrigation district had what it claimed were surplus funds—but which the Supreme Court said were not surplus funds—and the district went out and bought bonds, and the proceeding was to set aside that sale. The Supreme Court said that created a preference in favor of the junior bondholders against those who had their bonds registered. It set aside the preference which had by the action of the district favored the junior bondholders. In the *El Camino District* case, decided at the same time, the Supreme Court held the bondholders who had a judgment against the district couldn't get execution. Why not? Among other things, because it would give them preference. It would allow them preference in the property of the district as against other bondholders who followed *Bates v. McHenry* and registered the bonds. The Supreme Court held the property of the district was exempt from execution and at the same time it held in *Clough v. Compton-Delevan Irr. Dist.*, 12 Cal. (2d) 385, that the bondholder was not entitled to partition the lands.

In the *Provident* case the district was probably insolvent, but the case did not come up on that question or on a question of bankruptcy; it simply came up on the question of whether the bondholder who got a preference by selling his bonds to the district was entitled to maintain that preference as against the registered bondholder who had been frozen out—a very different proposition from what we have here.

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9. *Provident Land Corp. v. Zumwalt*, 12 Cal. (2d) 365, 85 P. (2d) 116; *Moody v. Provident Irr. Dist.*, 12 Cal. (2d) 389, 85 P. (2d) 128; *El Camino Irr. Dist. v. El Camino Land Corp.*, 12 Cal. (2d) 378, 85 P. (2d) 123; *Clough v. Compton-Delevan Irr. Dist.*, 12 Cal. (2d) 385, 85 P. (2d) 126.

I hazard the assertion in closing this point, your Honors, that in every case in which *Bates v. McHenry* has been cited, and in every case in which Section 52 has been cited, the Court has held in effect that it will not permit a preference as between bondholders, and yet those cases and that section are being used here as authority for the proposition that the registered bondholder gets a preference in bankruptcy; and the cases clearly do not establish any such thing.

Judge Denman. We will recess until two o'clock.

(A recess was thereupon taken until two o'clock p. m.)

AFTERNOON SESSION.

Argument of Stephen W. Downey (continued).

Mr. Downey. Your Honors, in concluding my argument on *Bates v. McHenry,* I omitted reference to the case of *District Bond Company v. Cannon,* 20 Cal. App. (2d) 659, 67 P. (2d) 1090, which is the "Spotted Calf" case in the State courts; and leaving that out is like attempting to play Hamlet and leaving out Hamlet. That case arose under the Acquisition and Improvement Act of 1925 and that is the only statute of the State of California in which it has been finally held that there is an absolute unrestricted, inexhaustible power of taxation by the United States Supreme Court.[10] In that case, the question

10. *American Securities Company v. Forward,* 220 Cal. 566, 32 P. (2d) 343. affirmed Supreme Court of the United States under the title *Irones v. American Securities Co.,* 294 U. S. 692, 55 S. Ct. 403, 79 L. ed. 1232.

was whether, since there was an inexhaustible power of taxation behind the district, the money should be paid in the order in which the bonds were presented, as in *Bates v. McHenry* even though the district was insolvent in fact. The District Court of Appeal held that if as a matter of fact the capacity to collect the tax was gone the funds should be prorated, relying on the *Port of Astoria* case, from Oregon, and the *Kerr Glass Manufacturing Co.* case, from our own Supreme Court. The case went to the Supreme Court on a petition for rehearing, and the petition was denied, so we feel that on the State law we have a clear holding that if the power of taxation, although unlimited, theoretically, has been lost through the inability to collect, then all stand on a parity. I didn't stress that particularly in my brief, and therefore I do so now.

May it please the court, the other points will be discussed by counsel for the other districts; I think we are all interested in them. I might say, I would like to have my argument written up, and I would like to fill in my citations and references and cases and check the quotations and file it as a part of the record in this case.